Income Producing Activity from
Activities Performed on behalf of a Taxpayer

In general, under section 17 of UDITPA, if a taxpayer has a receipt from a sale of other than tangible personal property, and the income producing activity related to that sale occurs in more than one state, that sale is assigned to the numerator of the sales factor of the state where the greater income producing activity is located, based on cost of performance. In such case, the state with the greater cost of performance is the state to which the sale is assigned for purposes of the sales factor numerator.

It is common for a taxpayer that contracts to perform a service to delegate or subcontract all or a portion of the actual performance of the contract to a third party. Under MTC Reg.IV.17(2), income producing activity "does not include the transactions and activities performed on behalf of a taxpayer, such as those conducted by independent contractors." That implies that a cost paid to another entity that performs a service on the taxpayer's behalf is not considered a cost of performance for purposes of determining the location of the greater cost of performance.

To illustrate: Assume a taxpayer contracts with a customer to perform a service for $1 million, and hires a subcontractor to perform that service in state B. Assume that the taxpayer will incur costs of its own in State A of $100,000, and will pay $500,000 to the subcontractor to perform the rest of the service in State B. If the costs paid to the subcontractor acting on behalf of the taxpayer are disregarded, the greater cost of performance ($100,000) is located in State A, and the $1 million sale would be in numerator of the State A sales factor. If the costs paid to the subcontractor acting on behalf of the taxpayer were considered, the greater cost of performance ($500,000 of $600,000) would be located in State B and the $1,000,000 sale would be in the numerator of the State B sales factor.

It is unclear what the scope is of "on behalf of" actors whose costs are disregarded for purposes of the cost of performance rule. There is a range of "on behalf of" actors that include 1) employees, 2) members of a combined reporting group 3) members of a unitary group[1] 4) an affiliated but not unitary corporation 4) an individual acting as an agent,[2] 5) a corporation acting as an agent, and 6) independent contractors (whether individuals or corporations).

While an employee in some sense acts "on behalf of" the corporation for which he or she is employed, a fairly strong argument can be made that employee salaries should not be disregarded as a cost of performance under the "on behalf of" rule. MTC Reg.IV.17(2)states, in

[1] A unitary group is broader than a combined reporting group, as it might encompass entities that have a unitary "contribution or dependency relationship" but are not in the combined reporting group, such as members excluded by a water's edge rule, or an insurance company, etc.

[2] For purposes of this discussion, an agent is a person or entity sufficiently acting under the control and supervision of a principal so as to be not considered an "independent contractor."

part, "…Accordingly, income producing activity includes but is not limited to the following: (A) The rendering of personal services by employees…in performing a service." Thus, despite the fact that an employee acts "on behalf of" his or her employer, the services of an employee are considered income producing activities of the taxpayer. This is further supported by the fact that the payroll factor in the apportionment formula includes salaries paid to employees. Thus, employees are probably appropriately viewed as an extension of the taxpayer itself.

Next in the range of "on behalf of" actors is a member of the taxpayer's combined reporting group. In a *Finnigan* state, the whole of the unitary enterprise is a "taxpayer" for apportionment purposes so it should be expected that acts by one unitary member "on behalf of" another would be treated as acts of component parts of the same "taxpayer." In a *Joyce* state, however, for purposes of the numerator of the sales factor, each "taxpayer" member of a combined reporting group is considered a distinct entity, and one could argue that the costs incurred by a subcontracting member of the group, and intercompany payments to that member, are not "income producing activities" of the prime contractor taxpayer that actually receives the receipt from its customer.

If that were the proper interpretation of the cost of performance rule, however, taxpayers would have a substantial planning opportunity, because the prime contractor could substantially control the location of the numerator state by either performing the contract itself (in the example, by performing the service in State B) or hiring a member of its group to perform the contract (shifting the receipt to State A). This result, apart from the planning opportunity, seems to be counterintuitive, because intercompany sales are generally eliminated from the sales factor of the combined reporting group on the theory that those sales do not produce currently taxable income to the group as a whole until the benefit of that sale is realized on the customer's payment to the taxpayer. If an intercompany sale were not eliminated, there would be two sales: (1) the sale to the member of the combined reporting group, which would take into account the subcontractor's own costs in State B, and (2) the sale to the prime contractor's customer, which would take into account the prime contractor's costs in State A. There is logical force for the argument that the ultimate sale to the third party represents the economic benefit culminating from the efforts of two parts of the same unitary enterprise, and that if the intercompany sale is to be disregarded because it isn't a true sale of the enterprise, both cost components should be reflected in the ultimate receipt.

Similar planning opportunities would arise for affiliated members that are not members of the combined group, but at least in that context, intercompany sales and the corresponding cost of performance would be reflected in the separate sales factor of the non-combined or nonunitary seller.

The origins of the MTC's "on behalf of" rule are unclear. There may be a hint of a rationale in the fact that that amounts paid to independent contractors are disregarded in the cost of performance rule and are also excluded from the payroll factor. These rules may have reflected a notion that acts of an independent contractor were remote from the acts of the taxpayer and thus not properly chargeable to the taxpayer. This would be consistent with the cases that pre-date *Scripto v. Carson* that adopted a principle that acts of an independent contractor were not acts of the party for whom they acted. Section 17 doesn't have a throwback rule, so if a cost of performance is incurred in a state where the taxpayer doesn't have nexus, there is no standard mechanism in that statute or regulation for preventing a "nowhere sale." On the other hand, the view that an independent contractor doesn't confer nexus on the out-of-state seller was rejected in *Scripto*, at least in the context of a sales solicitation. *Scripto* was a 1959 case, decided well before the MTC regulation was completed in 1972.

Another reason the "on behalf of" rule might have been adopted to avoid the audit difficulties associated with determining the location where the "on behalf of" actor actually performed its portion of the services under the contract. If the prime contract with the taxpayer's customer calls for the performance of a service in a specific state, or the service can only be done in that state (e.g., an earth-moving contract), it is not that difficult to identify the location that the "on behalf of" actor actually performed the service. In other cases, however, the "on behalf of" actor might have discretion as to where its portion of the service is to be performed. For example, if a subcontractor is adding component value to an advertising contract, it might be able to perform its subcontracting services anywhere. In still other cases, a subcontractor might "outsource" its subcontracting services to still another party. As the actors become increasingly more remote from the prime contracting party, identification of the location of costs of performance becomes increasingly more difficult.

Moreover, if the independent contractor (or the independent contractor's own subcontractor) has discretion as to where its portion of the contract is performed, it is possible that *Scripto v. Carson* would not impute nexus to the taxpayer in the state where the subcontractor services are performed, on a theory that the acts in that state were not "purposefully directed" by the taxpayer. In that case, if amounts paid to an independent contractor would be considered a cost of performance, it would still be possible to have the greater cost of performance located in a state where the taxpayer does not have nexus.

One could argue that the "on behalf of" rule should be ***limited to*** independent contractors. However, such an interpretation would appear to be inconsistent with language of the rule itself, which applies to those acting on behalf of a taxpayer "*such as*" independent contractors. The phrase "such as" implies that the scope of the "on behalf of" rule is broader than independent contractors alone. Thus, costs paid to a non-independent contractor agent (i.e., under the control and supervision of its principal) might also be excluded from costs of performance under the "on behalf of" rule.

Of interest to this inquiry, in *General Motors Corp. v. Commonwealth*) [(Record No. 032533) (September 17, 2004) (Doc 2004-18598)] the Virginia Supreme Court held that third party costs should NOT have been disregarded in that state's cost of performance ratio used for financial institutions. The court found nothing in the language of the Virginia statute that limited the costs of performance to direct costs or anything to suggest that the department was permitted to exclude costs incurred for activities performed on behalf of a taxpayer by a third party.

The issues to be addressed:

1) Should the "on behalf of rule" be stricken from the MTC regulation?

2) If the rule is stricken,

    a. Should there be a rule to deal with the audit problems described above? Is a throw-out or throwback rule needed where the taxpayer cannot identify where the subcontractor actually performed the service?

    b. Is a throw-out or throwback rule needed for costs of performance that are incurred in a state or country where the prime contractor does not have nexus?

    c. If a throw-out or throwback rule is adopted, should it be promulgated under section 18 of UDITPA?

3) If the rule is to be retained, what is the scope of those subcontractor payments that are excluded from the cost of performance rule?

    a. Should payments to a subcontractor that is a member of the taxpayer's combined reporting group be excluded from the cost of performance rule?

    b. If not, should the regulation be clarified to treat the services of a subcontracting member of the combined reporting group as income producing activity of the prime contractor?

    c. Should the regulation be amended to treat amounts paid to all affiliate member subcontractors as the prime contractor's cost of performance, whether or not the affiliate is combined, and whether or not it is unitary?

    d. Should amounts paid to all subcontractors be considered as a cost of performance of the taxpayer *except* those amounts paid to a true independent contractor? Would this raise difficult audit issues determining whether the subcontractor is really an independent contractor or an agent?